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Supreme Court of the United States

OCTOBER TERM, 1977

No. 77—695

AMERICAN PUBLIC GAS ASSOCIATION, *et al.*,
Petitioners,

v.

FEDERAL ENERGY REGULATORY COMMISSION, *et al.*,
(Formerly Federal Power Commission)
Respondents.

On Petitions for Writs of Certiorari to the
United States Court of Appeals
for the District of Columbia

BRIEF OF THE UNITED DISTRIBUTION COMPANIES IN OPPOSITION

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IDENTIFICATION OF UNITED DISTRIBUTION COMPANIES

CENTRAL ILLINOIS PUBLIC SERVICE CO.

CITIZENS GAS & COKE UTILITY

COLUMBIA GAS SYSTEM
- Columbia Gas of Kentucky, Inc.
- Columbia Gas of Maryland, Inc.
- Columbia Gas of New York, Inc.
- Columbia Gas of Ohio, Inc.
- Columbia Gas of Pennsylvania, Inc.
- Columbia Gas of Virginia, Inc.
- Columbia Gas of W. Virginia, Inc.

CONSOLIDATED NATURAL GAS COMPANY

CONSOLIDATED GAS SUPPLY CORP.
- The East Ohio Gas Company
- The Peoples Natural Gas Co.
- The River Gas Company
- West Ohio Gas Company

CONSUMERS POWER COMPANY

DAYTON POWER AND LIGHT COMPANY

EQUITABLE GAS COMPANY

ILLINOIS POWER COMPANY

INDIANA GAS COMPANY

MICHIGAN CONSOLIDATED GAS CO.

MICHIGAN GAS UTILITIES COMPANY

NATIONAL FUEL DISTRIBUTION CORPORATION

NIAGARA MOHAWK POWER CORPORATION

NORTHERN ILLINOIS GAS COMPANY

ORANGE & ROCKLAND UTILITIES, INC.

PEOPLES GAS COMPANIES
- North Shore Gas Company
- The Peoples Gas Light and Coke Company

WISCONSIN GAS COMPANY

TABLE OF CONTENTS

	Page
OPINIONS BELOW	1
JURISDICTION	2
STATUTE INVOLVED	2
COUNTER-STATEMENT OF THE CASE	2
I. DESCRIPTION AND INTEREST OF THE UNITED DISTRIBUTION COMPANIES	2
II. BACKGROUND DECISIONS	3
III. HISTORY OF THIS PROCEEDING	5
ARGUMENT	9
REASONS FOR DENYING THE WRIT	9
I. SUMMARY STATEMENT	9
II. THE COURT OF APPEALS DID NOT—AS CHARGED BY THE PETITION—"ABANDON" THE SUBSTANTIAL EVIDENCE STANDARD; NOR DID IT "SUBSTITUTE A HYBRID (AND LESSER) STANDARD OF ITS OWN MANUFACTURE"	11
A. The Court's References To Its Equitable Powers Under 28 U.S.C. § 2106	12
B. The Court's Approval Of The Use Of AGA Reserves Data	13
C. The Court's Determination That The Commission's Tax Allowance Is Supported By Substantial Evidence	14
D. The Tests of *Permian* And *Mobil* Have Clearly Been Satisfied By The Court Below	17

III. THE COURT OF APPEALS PROPERLY APPROVED THE COMMISSION'S TAX ALLOWANCE 18

A. The Change In Tax Policy Was Justified 18

B. The "Actual Taxes Paid" Issue 19

C. The Consolidated Income Tax Returns 21

IV. THE COURT OF APPEALS PROPERLY APPROVED THE PROCEDURES UTILIZED BY THE COMMISSION 24

TABLE OF CITATIONS

Page

CASES:

American Public Gas Ass'n. v. FPC, 498 F.2d 718 (D.C. Cir. 1974) 4, 24, 26

Atlantic Seaboard Corporation v. FPC, 404 F.2d 1268 (D.C. Cir. 1968) 23

City of Chicago v. FPC, 385 F.2d 629 (D.C. Cir. 1967), *cert. denied*, 390 U.S. 945 (1968) 23

Consolidated Gas Supply Corporation v. FPC, 520 F.2d 1176 (D.C. Cir. 1975) 23

Consolidated Edison Co. v. NLRB, 305 U.S. 197 (1938) 13

Consolo. v. Federal Maritime Commission, 383 U.S. 607 (1966) 13

FPC v. Florida Power and Light Co., 404 U.S. 453 (1972) 13

FPC v. United Gas Pipe Line Co., 386 U.S. 237 (1967). 21, 22

FPC v. United Gas Pipe Line Co., 393 U.S. 71 (1968) . 21, 22

Mobil Oil Corp. v. FPC, 417 U.S. 283 (1974) ..... passim

Mobil Oil Corp. v. FPC, 483 F.2d 1238 (D.C. Cir. 1973) 26

NLRB v. Nevada Consolidated Copper Corp., 316 U.S. 105 (1942) 13

Permian Basin Area Rate Cases, 390 U.S. 747 (1968) .. passim

Phillips Petroleum Co. v. FPC, 475 F.2d 842 (10th Cir. 1973), *cert. denied sub nom., Chevron Oil Co. v. FPC*, 414 U.S. 1146 (1974) 4, 24

Public Service Commission for the State of New York v. FPC, 511 F.2d 338 (D.C. Cir. 1975) 23

Shell Oil Co. v. FPC, 520 F.2d 1061 (5th Cir. 1975), *cert. denied sub nom., California Co., et al. v. FPC*, 426 U.S. 941 (1976) 5, 13, 24

U.S. v. Allegheny-Ludlum Steel Corp., 406 U.S. 742 (1972) 24

U.S. v. Florida East Coast Railway Co., 410 U.S. 224 (1973) 24

ADMINISTRATIVE DECISIONS, ORDERS, AND OPINIONS:

Area Rate Proceeding (Permian Basin Area II), 50 F.P.C. 390 (1973) 3

Area Rate Proceeding (Southern Louisiana Area), 40 F.P.C. 530; *reh. granted*, 40 F.P.C. 1091 (1968); Opinion No. 546-A and order issued, 41 F.P.C. 301 (1969); *aff'd sub nom., Southern Louisiana Area Rate Cases*, 428 F.2d 407, *aff'd on rehearing*, 444 F.2d 125 (5th Cir.), *cert. denied*, 400 U.S. 950 (1970) 4

Area Rate Proceeding (Southern Louisiana Area), 46 F.P.C. 86; *modified*, 46 F.P.C. 633 (1971) 4

Just and Reasonable National Rates for Sales of Natural Gas, 51 F.P.C. 2212 (1974) 5

Just and Reasonable National Rates for Sales of Natural Gas, 52 F.P.C. 1604 (1974) 5

STATUTES AND REGULATIONS:

Administrative Procedure Act, 5 U.S.C. 551, *et seq.* 25

§ 556 25

§ 557 25

Natural Gas Act, Section 4(e), 15 U.S.C. §717c(e) 2, 24

Natural Gas Act, Section 19(b), 15 U.S.C. §717r(b) 2, 25

28 U.S.C. §1254 2

28 U.S.C. § 2106 12

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BRIEF OF THE UNITED DISTRIBUTION COMPANIES IN OPPOSITION

United Distribution Companies (UDC) hereby state their opposition to the petitions for a writ of certiorari to review the judgment and opinion of the United States Court of Appeals for the District of Columbia entered in this case on June 16 and August 17, 1977, in the Second National Natural Gas Rate Cases.

OPINIONS BELOW

The initial opinion of the Court of Appeals (APGA, A.1)[1] and its opinion on rehearing (APGA, A.130) are not reported.

[1]Pages of the APGA Appendix to its Petition is referred to throughout this Brief as "APGA, A. ___".

JURISDICTION

The judgment of the Court of Appeals was entered on June 16, 1977. (APGA, A. 1) Timely petition for rehearing was denied by order entered on August 17, 1977. (APGA, A. 130) This Court's jurisdiction is invoked by Petitioners under 28 U.S.C. § 1254 and § 19(b) of the Natural Gas Act, 15 U.S.C. § 717r(b).

STATUTE INVOLVED

The relevant provisions of Sections 4(e) of the Natural Gas Act, 15 U.S.C. § 717c(e) and Section 19(b) of the Natural Gas Act, 15 U.S.C. § 717r(b) are set out as Appendices F and G respectively of the Appendix to APGA's petition.

COUNTER-STATEMENT OF THE CASE

I. DESCRIPTION AND INTEREST OF THE UNITED DISTRIBUTION COMPANIES

The United Distribution Companies constitute an *ad hoc* group of twenty-eight gas distribution utilities which, taken as a group, are responsible for approximately twenty-five percent of the gas utility service to consumers throughout the United States. Its members serve more than ten million metered customers, representing a population of more than forty-eight million persons.[2]

UDC was organized because of the inability of its members to purchase sufficient gas with which to meet their public utility obligations. The UDC Group has participated in all stages of the proceeding before the Federal Power Commission and the Court below, and also has participated in numerous prior area rate and rulemaking proceedings before the FPC. UDC seeks to encourage the promulgation of just and reasonable rates which

[2]A list of UDC member companies is included on the inside cover.

will bring about the exploration for and dedication of natural gas reserves requisite to the elimination of the current natural gas shortage in the interstate market.

II. BACKGROUND DECISIONS

FPC Opinions 770 and 770-A are the latest in a series of attempts by the FPC to find just and reasonable rates on an average or aggregate basis for wellhead sales of natural gas for the interstate market.

In the first landmark area rate case, *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968) (hereinafter called *Permian)*, this Court upheld the authority of the Commission to make rates on an area basis. There followed a series of area rate proceedings, involving the Appalachian, Southern Louisiana, Rocky Mountain, Texas Gulf Coast, and other Southwest areas, ending in 1973 with the second Permian case.[3]

This Court considered two of those area cases, the initial *Permian* case, *supra*, and the second Southern Louisiana case, *Mobil Oil Corp. v. FPC*, 417 U.S. 283 (1974) (hereinafter called *Mobil)* In both *Permian* and *Mobil*, this Court laid down the standard for review of area rate proceedings.

> It follows that the responsibilities of a reviewing court are essentially three. First, it must determine whether the Commission's order, viewed in light of the relevant facts and of the Commission's broad regulatory duties, abused or exceeded its authority. Second, the court must examine the manner in which the Commission has employed the methods of regulation which it has itself selected, and must decide whether each of the order's essential elements is supported by substantial evidence. Third, the court must determine whether the order may reasonably be expected to maintain

[3]Area Rate Proceeding (Permian Basin Area II), 50 F.P.C. 390 (1973).

> financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable. The court's responsibility is not to supplant the Commission's balance of these interests with one more nearly to its liking, but instead to assure itself that the Commission has given reasoned consideration to each of the pertinent factors. 390 U.S. at 791-792.

The early area rate decisions were conducted by the question and answer process and required years for the development of the record. The hearings leading up to *Permian, supra*, for example, began in 1961 and the Commission decision could not be issued until 1965. The first Southern Louisiana proceeding also commenced in 1961 and the first Commission decision was not issued until 1968.[4] The case was reopened and the FPC consolidated it with Southern Louisiana II; a final decision was not issued until 1971.[5] The inordinate time period involved in the making of new rate by that adversary process compelled the Commission to shift to a rulemaking technique in which sworn testimony was received via written comments of the various parties. In *American Public Gas Ass'n. v. FPC*, 498 F.2d 718 (D.C. Cir. 1974), the court below upheld the authority of the Commission to fix area rates in a rulemaking proceeding after due notice and opportunity for interested parties to file evidence, comments, and reply comments. The fixing of area rates in a rulemaking proceeding was also upheld in *Phillips Petroleum Co. v. FPC*, 475 F.2d 842 (10th Cir. 1973), *cert. denied sub nom., Chevron Oil Co. v. FPC*, 414 U.S. 1146 (1974).

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[4]Area Rate Proceeding (Southern Louisiana Area), 40 F.P.C. 530; *reh. granted*, 40 F.P.C. 1091 (1968); Opinion No. 546-A and order issued, 41 F.P.C. 301 (1969); *aff'd sub nom., Southern Louisiana Area Rate Cases*, 428 F.2d 407, *aff'd on rehearing*, 444 F.2d 125 (5th Cir.), *cert. denied*, 400 U.S. 950 (1970).

[5]Area Rate Proceeding (Southern Louisiana Area), 46 F.P.C. 86; *modified*, 46 F.P.C. 633 (1971).

After more than ten years of fixing rates on an area-by-area basis and being faced with the constant reevaluation of these cases, the Commission, in 1973, determined to establish group ceiling rates on a national basis. It, therefore, commenced Docket No. R-389-B to fix ceiling rates for wellhead sales in all producing areas; and this rulemaking proceeding culminated in 1974 in the decisions known as Opinion 699[6] and 699-H.[7] This rulemaking process and the rates prescribed were reviewed and approved in *Shell Oil Co. v. FPC*, 520 F.2d 1061 (5th Cir. 1975), *cert. denied sub nom., California Co., et al. v. FPC*, 426 U.S. 941 (1976) (hereinafter called *Shell*).

III. HISTORY OF THIS PROCEEDING

The instant proceeding was initiated by order of the Commission issued December 4, 1974, in Docket No. RM75-14. This order followed the same rulemaking procedure which was used in Docket No. R-389-B, and which, as stated above, received judicial approval; and it called upon the parties to submit evidence on several critical issues of fact.

The purpose of the proceeding was to determine just and reasonable rates for jurisdictional sales of natural gas dedicated to interstate commerce on and after January 1, 1973 and for the biennium from January 1, 1975 to and including December 31, 1976 "and otherwise regulating such jurisdictional sales by natural gas producers on a nationwide basis". The Commission, in its notice, stated:

> We do not, at this time, propose a specific rate for the 1975-76 biennium or other revisions to the rules prescribed in section 2.56a. We will, instead, rely upon the responses filed in this proceeding as the basis for modifying section 2.56a.

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[6]Just and Reasonable National Rates for Sales of Natural Gas, 51 F.P.C. 2212 (1974).

[7]Just and Reasonable National Rates for Sales of Natural Gas, 51 F.P.C. 1604 (1974).

The Commission's notice required the filing of written comments under oath on or before January 17, 1975 and responses thereto on or before February 14, 1975. It became apparent that evidence could not be compiled and filed on such a schedule, and on motions filed by various parties indicating that the schedule could not be met and other requests for continuances, the time for filing was extended, from time to time, until May, 1975.

On May 14, 1975, UDC filed sworn statements of five expert witnesses, including extensive testimony and detailed studies, as to productivity, other costs, intrastate drilling and prices, and other subjects bearing directly on the fixing of rates, as well as detailed studies of the adverse effects of the gas shortage upon ultimate consumers.

Also during May and early June, numerous other parties submitted comments to the Commission; but only one other group of parties—the Indicated Producer Respondents (IPR)—submitted detailed evidence upon the issues. Many parties merely submitted statements of counsel and others submitted evidence on selected issues, such as the cost of deeper drilling and the cost of production from the Appalachian Area. But the only comprehensive evidentiary presentation from which rates could be determined were those of UDC and IPR.

On June 13, 1975, the Commission issued an interim order instituting a special investigation designed to update a Staff study which had been introduced in Docket No. R-389-B and which involved Staff reserve estimates for 31 offshore leases. Since the Staff estimates for these leases were quite high in relation to reserve estimates prepared by the American Gas Association (AGA) on an area-by-area basis, the Staff study had been used in Docket No. R-389-B as a basis for questioning the use of AGA estimates in determining the productivity of drilling. The Commission, therefore, desired that the subject be investigated further in this proceeding.

On June 16, 1975, the Commission issued an interim order requesting the parties to file comments on the use of intrastate

prices in the fixing of new ceiling rates. UDC, on July 24, 1975, filed sworn expert testimony which supplemented its evidence of May 14 on this subject and presented a detailed analysis of the competitive situation in the market, the economic factors present within it, and the close relation between price and the costs which producers will incur in drilling for gas. Evidence on these subjects was also presented by IPR.

On July 24, 1975, the UDC Group also presented important new studies, prepared and sworn to by expert witnesses, showing the cost of drilling for gas offshore in the Gulf of Mexico, which studies were directly predicated on reserve estimates prepared for UDC by the United States Geological Survey, on drilling, leasing, and other critical data taken from the records of the Department of Interior, and on a special study of offshore drilling costs.

On August 4, 1975, the Commission issued an interim order to which were attached two separate cost analyses and rate recommendations prepared by the Bureau of Natural Gas (BNG) and the Office of Economics (OEC). The two studies used quite different costing techniques and arrive at widely divergent results.

Comments on the two separate studies were filed by the parties in September, 1975. The UDC Group, on September 5, presented expert evidence on the subject and at the same time updated its earlier study of the cost of producing gas in onshore fields in the Midcontinent and Gulf Coast areas.

On October 3, 1975, the Commission issued a further order to which was attached a supplementary OEC study substantially modifying its August 4 study. Comments of various parties on this new study were thereafter filed—that of the UDC Group including sworn expert testimony on the subject.

Thereafter, the case lay dormant until March 3, 1976, when the Commission issued an order to which was attached still another cost study and rate recommendation prepared by the Bureau of Natural Gas. Various parties filed comments and reply

comments during April and May. UDC again filed expert testimony on the subject.

During the spring of 1976, the Commission was awaiting the completion of the Staff investigation of the so-called 31 Lease Report—initiated on June 13, 1975 and implemented by several succeeding orders. This Staff investigation was completed in June; and on June 21, 1976, the Commission issued an order to which the Staff report was attached. Comments on the Staff report were filed by four parties. The Staff report concluded, after long study and the review of subpoenaed documents, that the AGA estimate of total proven reserves was reasonable. The year in which a field was deemed proven by AGA sometimes differed from the timing used by the Staff, and this has created the apparent discrepancy which resulted in the investigation.

Thereafter, on July 27, 1976, the commission issued Opinion 770. Numerous applications for rehearing were filed.

Oral argument was held on September 16 and 17, 1976. During its course, UDC presented an argument and submitted to the Commission six schedules of computations filed as Exhibit UDC-1.

Opinion 770-A thereafter was issued on November 5, 1976.

In total UDC filed seven sets of comments in the proceeding below. Five sets contained sworn evidence by expert witnesses including extensive detailed data.

In Opinions 770 and 770-A on rehearing, the Commission devoted hundreds of pages to a detailed evaluation of the evidence. It explored the evidentiary base and explained how its findings and conclusions were based thereon. The opinions are almost textbook models of how an administrative agency should arrive at cost findings based upon an analysis of the evidence.

After the timely filing of applications for rehearing, numerous appeals were filed in various circuit courts of appeals. All of these appeals were ultimately transferred to the Court

below. Because of the importance of the case, the Court below expedited the proceeding and, after briefing, held two days of oral argument on March 23 and March 24, 1977. On June 16, 1977, the Court below entered its order affirming the Commission's opinions in their entirety, and applications for rehearing were denied by order entered August 17, 1977. Judge Fahy dissented in part.

ARGUMENT

REASONS FOR DENYING THE WRIT

I. SUMMARY STATEMENT

The Petition of APGA *et al.* for a writ of certiorari, charges that the Court of Appeals on review below: (1) failed to apply the substantial evidence standards of this Court's decisions in *Permian, supra,* and *Mobil, supra,* and substituted something lesser of its own "manufacture"; (2) "overruled", "disregarded" and "arbitrarily ignored" the judicial decisions of this and other Courts as to the way in which a regulated tax allowance may be determined; and (3) sustained regulatory procedures which are contrary to the Natural Gas Act, the Administrative Procedure Act, and judicial precedent.

These serious charges are totally belied by the comprehensive opinions of the Court below, as we will set forth in some detail.

But, in essence, the following stands out clearly:

1. The Court fully recognized the grave importance of the case and gave lengthy and detailed consideration to every contention made by Petitioners in their appeal.

2. On every issue, the Court carefully analyzed the Commission's motives for its action, the reasoning with

which it solved the thorny regulatory problems which were involved and the justice of the results which were achieved.

3. The Court carefully considered the evidence on which the Commission predicated its actions and found this evidence sufficient for the purpose of its decision. And, in this connection:

   (a) It fairly and frankly discussed the concerns which both Court and Commission had with regard to certain data in the record and found the evidence to be sufficient; and

   (b) It carefully analyzed the desires of Petitioners for additional evidence on certain issues and the desire of Judge Fahy for additional evidence on the tax issue, but found the record support adequate in the absence of such evidence.

4. The Court dealt in detail with all of the issues of law as to tax matters and demonstrated that the Commission's action was consistent with all relevant judicial precedents.

5. The Court found that the procedure here used was fully justified by the Natural Gas Act, the Administrative Procedure Act and judicial precedent and that a fair hearing had in fact been conducted.

6. The decision below is not in conflict with any decision of this Court or any decision of any court of appeals.

In sum, the Court below properly reviewed this important proceeding. Clearly, to use the words of this Court's prior decision in *Mobil, supra,* the Court below did not "misapprehend". It did not "grossly misapply". This is not, therefore, one of those instances in which this Court should feel the necessity to intervene.

It is respectfully submitted that the Petition of APGA, *et al.* for a writ of certiorari should be denied.

II. THE COURT OF APPEALS DID NOT—AS CHARGED BY THE PETITION—"ABANDON" THE SUBSTANTIAL EVIDENCE STANDARD; NOR DID IT "SUBSTITUTE A HYBRID (AND LESSER) STANDARD OF ITS OWN MANUFACTURE"

The Supreme Court has previously dealt with area rate proceedings of the Federal Power Commission. In *Permian, supra,* and *Mobil, supra,* this Court defined the scope of judicial review as well as the responsibilities of the courts of appeals in such cases.

In the instant case, this Court can hardly read the opinion of the Court below without being impressed by the thoroughness with which it has examined each issue and by its careful determinations that the Commission's findings were well reasoned and properly supported.

As is evident, this was an extremely important and well litigated matter. The printed record before the Court of Appeals, alone, ran to six volumes; and the two opinions of the Commission are long and exhaustive. On each issue raised on appeal, the Court of Appeals carefully examined the action which has been taken as well as the reasoning and evidentiary support on which it rested. Carefully applying *Permian, supra,* and *Mobil, supra,* it found that the Commission had given reasoned consideration to each matter before it and that the evidentiary support, was, in its opinion, substantial.

The Court below was clearly concerned by the absence of certain additional facts which both Commission and Court would like to have seen in the record, but it recognized the public interests which required that action be taken and it found the record adequate for regulatory action at this time.

While Petitioners claim that more evidence was needed on several issues—though in no case did they attempt to introduce evidence during the course of the proceeding—it is clear beyond peradventure: that the Court below did carefully weigh the evidence which lay at the base of the Commission's action; that

the Court appreciated the gravity and importance of the situation; that it fully "apprehended" the requirements of *Permian, supra, Mobil, supra,* and the Natural Gas Act, and that it did not "grossly misapply" them.

The opinion below is a model of careful judicial concern for the requirements of this Court, the law, and the public interest. This is definitely not—to use the words of *Mobil*—an "instance when the standard appears to have been misapprehended or grossly misapplied". Hence, it is not a case in which this Court should feel called upon to examine the weight of the evidence.

A. The Court's References To Its Equitable Powers Under 28 U.S.C. §2106.

At page 16, the Petition quotes three passages from the long opinion in which the Court refers to its obligations under 28 U.S.C. § 2106 to further the interests of justice; and the charge is made that these statements represent a departure from the strict requirements for substantial evidence.

In a case of this portent, it seems laudable—rather than derelict—that the Court would concern itself with the justice of its actions as an adjunct to its strict powers of review. And in all instances, it is clear that the Court did not substitute justice for substantial evidence but that the two are used in correlation with one another.

When these passages were brought to the attention of the Court by Petitioner's application for rehearing, Judge Leventhal had this to say in the footnote at APGA, A. 132:

> The reference to § 2106 does not imply, as some petitioners for rehearing suppose, that the court has discarded the requirement of substantial evidence to support the Commissioners' findings and result. The court does feel bound in application of that standard to give deference to the Commission if it has asked the right questions and sought answers, and if it relies on material that is reasonably regarded as substantial in finding the answers. In the circumstance and with the information at hand, the economic model is substantial evidence. In the light of experience, the standard of substantial evidence might require the agency to take a different course.

B. The Court's Approval Of The Use Of AGA Reserves Data.

In charging "laxity" in the Court below, the Petition's first point at pages 14-19 deals mainly in generalities. But, at pages 18 and 19, it does cite the Court's treatment of the AGA reserves data, and we will deal briefly with this subject in response.

In its decision in this proceeding, as in all prior area rate proceedings[8], the Commission utilized data taken from the annual proven reserve studies of the AGA in determining the productivity of new drilling; and, as is plainly evident in the course of its opinion, (APGA, A. 50-62) the Court below had reservations about these industry data and frankly said so.

The Petition cites the Court's reservations with relish and contends that this destroys the Court's ultimate finding, at pages 61 and 62, that the AGA data did meet the substantial evidence standard.

It is obvious, and the Court so states, that both Commission and Court would like to see data other than the AGA series used as a basis for rate determinations. But the AGA series are the only data available at this time and have been used in determining area rates since the inception of this regulatory practice.

The fact that one would like an alternative does not render useless that which the record does contain. *See, Mobil Oil Corp. v. FPC, supra* at 318; *FPC v. Florida Power and Light Co.*, 404 U.S. 453, 563 (1972); *Consolo. v. Federal Maritime Commission*, 383 U.S. 607, 618-21 (1966); *NLRB v. Nevada Consolidated Copper Corp.*, 316 U.S. 105 (1942); *Consolidated Edison Co. v. NLRB*, 305 U.S. 197, 229 (1938).

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[8] *See*, for example, *Permian, supra,* and *Shell, supra.*

And the fact that the Court had reservations does not destroy its well reasoned conclusion that the Commission's determination was sufficiently supported for this proceeding. The Court's analysis of the necessities of the situation is compelling.

> To sum up: We do not approve or embrace the AGA figures; we simply tolerate them for purposes of this proceeding. We expect that by the next biennium the Commission will have put into effect its own procedures for gathering reserves data. To the extent AGA data remain for consideration, we contemplate that the Commission will have acquired information to permit further adjustments to the data supplied by the AGA. In the specific circumstances of this proceeding, we find that the Commission's productivity calculation is adequately supported.[72]

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[72]The dissenting Commissioner concluded that productivity should have been 354 Mcf/ft rather than 300 Mcf. R. 2692. From the judicial perspective, the zone of reasonableness may well embrace both figures. (APGA, A. 62)

C. The Court's Determination That The Commission's Tax Allowance Is Supported By Substantial Evidence.

The Petition at pages 22-24 continues its argument that, in dealing with the Commission's allowance for income taxes, the Court below failed to apply the "substantial evidence" rule as to the tax issue and substituted a lesser standard of its own. And, while we will deal with other tax issues in the following section of our brief, we will here respond to the evidentiary argument.

In this proceeding, as in all area and national rate proceedings, the Commission determined the rate or price for gas through the use of national statistics as to the costs incurred in drilling and operating wells. Using these as a base and applying to them the productivity of drilling, it arrived at a unit cost of gas

including the return—or income—element of that cost, and this is then translated into a rate. This is the basic concept approved by this Court in *Permian, supra;* and it has been utilized in area ratemaking ever since.

Thus, the price is uniformly determined by a pricing model based upon industry-wide—as distinguished from individual company—costs of drilling and operation, including, the essential return on investment associated with those industry-wide costs. And the further refinement adopted by the Commission in this case was the computation and allowance of the Federal income tax which would necessarily be paid if the industry earned the allowed return.

Petitioners no longer complain as to the pricing model. They complain only as to the tax allowance associated by the Commission with that return which results from the model.

The Commission's pricing model, including the tax element thereof, was fully supported in the record by sworn evidence submitted by the UDC Group and the Producer Group and by illustrative computations submitted by the Commission's Staff. And the Commission adopted and used the model as so supported.

The Court below described the operation of the model in depth and points out that, as applied, the benefit of all available tax deductions and benefits are flowed through to the consumer at the earliest possible point in time. (APGA, A. 29-30) The Court discussed the use of the economic model stating among other things:

(1) that, under the circumstances and in the light of the 1975 Amendment to the Internal Revenue Code, the Commission was clearly justified in seeking to account for taxes through use of the model (APGA, A. 37);

(2) that the model was entirely consistent with the "actual taxes paid" doctrine (APGA, A. 38); and

(3) that the Commission's reliance on the model for computation of the tax component was consistent with regulatory theory and fully justified in the light of the specific evidence available (APGA, A. 39).

The Court's conclusion on the issue (APGA, A. 48-50) states, *inter alia:*

> that the model is logical and takes into account all experience that is known and that can reasonably be anticipated; and
>
> that the model conforms in full measure to the requirement that the agency make a conscientious effort to seek answers and apply its knowledge and analysis with reasoned decision making.

Judge Fahy dissented on the tax issue—and Petitioners seek the action of this Court—on the ground that the model should not be used in the absence of additional evidence as to the tax returns of individual producing companies.

The opinion of Judge Leventhal deals with this issue seriously and conscientiously (APGA, A. 37-39, 48-50 and 131-132), and specifically finds that the model provides sufficient support for Commission action at this time and in the public interest, absent the additional evidence desired by Judge Fahy and Petitioners.

And, in illustration of the wisdom and propriety of the majority opinion, we cite the fact that the principle advocated by Judge Fahy and Petitioners is completely at war with area ratemaking as approved by this Court in *Permian, supra.* Area rates are based on average industry costs as distinguished from individual costs; and whether a producer will incur more or less than the average is of no consequence. In *Permian,* therefore, and in the proceeding below, the return to be earned stems from industry averages; and the tax computed by the Commission is that which must be paid if the average return is earned.

The model takes into account and flows through to the benefit of consumers every tax deduction available under the Internal Revenue Code as to the industry costs used in arriving at the rate. The examination of individual tax returns could in no way increase these deductions, as the opinion of Judge Leventhal makes plain (APGA, A. 30).

The question of whether individual producers will have tax reducing benefits from non-jurisdictional operations is considered below and Judge Leventhal finds that the Commission correctly dealt with this issue and that such additional evidence was not necessary in the record. (APGA, A. 40-42, 48-49).

Here again, as with productivity, the fact that Petitioners desire additional evidence does not render that which was in fact in the record insubstantial or useless.

D. The Tests Of *Permian* And *Mobil* Have Clearly Been Satisfied By The Court Below.

Turning to the governing dictates of this Court as set forth in *Permian, supra,* it is submitted:

(1) That the Court below, in exemplary fashion, determined that the Commission's order, viewed in the light of the relevant facts and of its broad regulatory duties, did not abuse or exceed its authority;

(2) That the Court soundly examined the manner in which the Commission employed the methods of regulation which it has itself selected;

(3) That the Court decided that each of the order's essential elements was supported by substantial evidence;

(4) That the Court determined that the order provides appropriate protection for the public interests; and

(5) That the Court assured itself that the Commission has given reasoned consideration to each of the pertinent factors.

Turning to *Mobil, supra*, it is clear, that the Court below understood and most carefully applied the substantial evidence standard. In *Mobil, supra* at 310, this court stated that whether on the record as a whole there is substantial evidence to support the Commission's findings is a question which Congress has placed in the courts of appeals. This Court will intervene only in what ought to be the rare instance when the standard appears to have been misapprehended or misapplied.

III. THE COURT OF APPEALS PROPERLY APPROVED THE COMMISSION'S TAX ALLOWANCE

Having dealt in the foregoing section with the evidentiary issue raised by the Petition, we now turn to the other tax issues raised at pp. 20-22 of the Petition.

In sum, the Petition contends that the Court below: (A) "overruled" prior cases in which the Commission had made no tax allowance; (B) "disregarded" the actual taxes paid doctrine of prior judicial decisions; and (C) "arbitrarily ignored" the tax reducing effects of consolidated income tax returns.

It is clear that the Court properly dealt with each of these matters and that there is no ground for charging error.

A. The Change In Tax Policy Was Justified.

The Petition charges, at page 21, that the Court below overruled all prior decisions of the Commission in which an allowance for Federal Income Taxes had been refused.

The Court of Appeals squarely dealt with this issue (APGA, A. 31-35). The Court points out that the change in Commission policy was brought about by, and squarely bottomed on the 1975 changes in the Federal Internal Revenue Code and that the Commission's finding that such change of law increased the tax burden of the producers by some 27 cents per Mcf was well grounded. The Court analyzed the reasoning of the Commission in support of the change.

Case after case has held that a governmental agency may change prior regulatory policy for good reason—*Permian, supra*, and *Mobil, supra*, are themselves examples of this fact. And the Court below was well within the standards laid down by this Court in concluding:

> . . . Precedent cannot be allowed to block the search for a model more reflective of economic reality. Here, where the agency had both meaningful reasons for changing its methodology and, as we develop more fully below, a logical explanation for the new approach it adopted, the law does not hold the agency fast to its prior policy. (APGA, A. 35)

B. The "Actual Taxes Paid" Issue.

At pp. 20 and 21, the Petition criticizes the Commission's determination of an income tax allowance through the use of its pricing model and contends that this action "disregards" the decisions of this Court and various courts of appeals under the "actual taxes paid" theory of regulation.

As set forth at pp. 35-39 of APGA's Appendix, the Court below carefully considered the use of an economic model for the determination of an income tax allowance and the propriety of the model in the light of the circumstances here presented and of the very judicial decisions now cited by the Petition. The Court specifically found:

> . . . The consumers interpret this principle to mean that an increment for taxes may be included in the price only after tax returns have been used to demonstrate tax liability. This involves misunderstanding of the case law dealing with that principle. Although there are a number of cases in this area,[29] we may usefully proceed from the summarizing discussion in *City of Chicago v. FPC*, 458 F.2d at 754-57 (1971). There we explained that the producers had for a long time

argued that the proper tax element of their rates was the tax that would have been paid but for certain deductions, chiefly those for depletion, intangible expenses and accelerated depreciation. The producers contended that because these deductions were intended to provide an incentive for participation in the production of a wasting asset, the companies should be allowed to retain any tax savings. The courts held, however, that since the ratemaking structure already included an allowance both for incentive and for depletion, the proper tax element was taxes actually paid. Tax savings were to be passed through the companies to the consumers.

The Commission's model is entirely consistent with this principle. At the very earliest date that the producers incur the cost of production, i.e. the pre-production expense of lease acquisition and drilling, the producers must reduce yield through a current credit for current tax savings. All applicable types of tax deductions are included. Hence, we find no deviation from the "actual taxes paid principle" in the Commission's use of an economic model.

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[29] *E.g., Cities of Lexington, Ky. v. FPC*, 295 F.2d 109 (4th Cir. 1961); *El Paso Natural Gas Co. v. FPC*, 281 F.2d 567 (5th Cir. 1960), *cert. denied sub nom California v. FPC*, 366 U.S., 912 (1961). (APGA, A. 37-38)

Moreover, at pages 38 and 39, the Court below addressed the impropriety of Petitioners "simplistic interpretation" of the "actual taxes paid" concept; and, while not considered by the Court in responding to Petitioners, we would, respectfully point out that the concept, for some time now, has been under serious attack both by regulatory authorities and by the accounting profession.

Finally, the Court concluded on this issue:

> In sum, the Commission's reliance on an economic model for computation of the tax component was consistent with regulatory theory and fully justified in light of the specific evidence available. (APGA, A. 39)

C. Consolidated Income Tax Returns.

The Petition contends at pp. 21-22 that the Court below "arbitrarily ignored" the reducing impact of the use of consolidated tax returns, "contrary" to this Court's *United I* and *United II* decisions.[9]

As set forth at pp. 40-42 and 48-49 of APGA's Appendix, the Court squarely dealt with this matter. There is nothing "arbitrary" about its decision. The Court's conclusion was a reasoned one predicated on the findings of the Commission which in turn were supported by the evidence.

The Court first carefully reviewed the *United* decisions and the Commission's position relative thereto and stated:

> We do not find it necessary to reach the legal issues raised by these arguments for we agree with the Commission that in the context of this national ratemaking proceeding, the savings which some producers may obtain from consolidation will not have industry-wide significance. Even the broadest reading of the decisions cited by the consumer interests could not reasonably preclude the Commission from making a net calculation on unregulated activities (setting losses off against gains from other nonjurisdictional activities) before combining the net figure with profits from jurisdictional sales. Thus, before a reduction of the tax component could be required, there would have to be a projection of a net nonjurisdictional loss on an industry-wide basis. The

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[9] *FPC v. United Gas Pipe Line Co.*, 386 U.S. 237 (1967); *FPC v. United Gas Pipe Line Co.*, 393 U.S. 71 (1968).

Commission specifically considered this possibility and dismissed it as neither supported by evidence nor "plausible" as a projection. (APGA, A. 41)

* * *

We have given the most respectful consideration to the views of our colleague Judge Fahy dissenting on this point, and to his concern that major oil companies may find ways of deferring taxes not presently reflected in the Commission model. Nevertheless, we think that the Commission's approach to this thorny issue is a reasonable one, and should be sustained at this time. (APGA, A. 48)

Implicit in much of Judge Fahy's concern is an assumption of losses in nonjurisdictional activities (and tax benefits from using those losses to reduce taxes due on jurisdictional sales). The Commission found it implausible that the producers as a whole would sustain losses in their unregulated activities while making gains in sales of regulated interstate gas. There is no evidence in the record to challenge that conclusion. It is certainly not unreasonable to presume, in the absence of contrary evidence, that the sphere of unregulated prices is likely to be more profitable. (APGA, A. 48-49)

The fact that this Court once upheld the authority of the FPC to require the reflection of consolidated tax savings in cost of service determinations does not prevent the Commission from formulating a new policy relative to consolidated tax savings when it feels that changed conditions so warrant. This is precisely the situation the Commission here confronted. In view of the increasing gas supply shortfall, there was an obvious need to change policy relative to consolidated tax savings in order to encourage additional exploration and development. As this Court itself indicated in the first *United* Opinion, "in the *proper circumstances* the Commission has the *power* to reduce cost of service, and hence rates, based on the application of

nonjurisdictional losses to jurisdictional income." (Emphasis added.) 386 U.S. at 246.

Reference to page 82 of Opinion No. 770-A will disclose that the Commission deemed it significant that this Court only said that the Commission had the "power" to require the reflection of tax savings. And it is quite clear that the Commission has the "power" to modify or even reverse an established policy. Commission policies *do* change as required to meet revised conditions, and the judiciary has consistently upheld these policy changes when supported by appropriate rationale. *Consolidated Gas Supply Corporation v. FPC*, 520 F.2d 1176, 1185 (D.C. Cir. 1975); *accord, Atlantic Seaboard Corporation v. FPC*, 404 F.2d 1268, 1273 (D.C. Cir. 1968); *City of Chicago v. FPC*, 385 F.2d 629, 637 (D.C. Cir. 1967), *cert. denied*, 390 U.S. 945 (1968). As the U.S. Court of Appeals for the District of Columbia circuit indicated in *Public Service Commission for the State of New York v. FPC*, 511 F.2d 338, 353 (1975):

> ... The legal system does not compel rigidity, or bureaucratic inflexibility, least of all in an area like energy policy where flexibility may be essential in the public interest. It is the genius of the administrative process to be flexible in response to observed developments, and an agency may "switch rather than fight the lessons of experience." (Footnotes omitted.)

In the present case the Court below stated the following in the course of its approval of the revised methodology utilized by the FPC relative to Federal income taxes:

> ... As we have already noted, *Greater Boston TV Corp. v. FCC* holds: "An agency's view of what is in the public interest may change either with or without a change in circumstances," as long as the agency changing its course supplies a "reasoned analysis indicating that prior policies are being deliberately changed, not casually ignored." 143 U.S. App. D.C. at 384, 444 F.2d at 852. In this case the Commission's modification of methodology is justified both because

it is responsive to changes in circumstance and because it is the product of a conscientious reexamination of the tax issue. (APGA, A. 31-32)

IV. THE COURT OF APPEALS PROPERLY APPROVED THE PROCEDURES UTILIZED BY THE COMMISSION.

The procedures utilized by the Commission in establishing the area rates here involved are attacked by Petitioners on the ground that they failed to include adversary hearings in which Petitioners were afforded the right of cross examination (Petition pp. 24-31). The issue is dealt with for the Court below in Judge Fahy's separate opinion for a unanimous court appearing at APGA, A. 94-101.

In the first national rate proceeding recently reviewed by the Fifth Circuit Court of Appeals in *Shell, supra,* the Commission utilized procedures identical with those here involved and APGA litigated the matter in that prior case. The Fifth Circuit affirmed the Commission and this Court denied APGA's petition for certiorari *sub nom., California Co. v. FPC, supra.*

Identical procedures were used in several earlier area rate proceedings. These area rate procedures were upheld by the Tenth Circuit in *Phillips Petroleum, supra,* in 1973, and this Court denied certiorari. They were likewise upheld by the Court of Appeals for the District of Columbia in *American Public Gas Association v. FPC, supra,* in 1974.

Thus, the ratemaking procedures here involved have been sustained by three Courts of Appeals in three prior cases and this Court has denied certiorari in two of them. Furthermore, APGA has briefed and argued the point in two such prior cases.

The Petition contends at pp. 24 and 26 that the area rate procedures utilized by the Commission are contrary to the "full hearing" requirement of Section 4(e) of the Natural Gas Act (15 U.S.C.§ 717c(e)). This point was specifically dealt with in the

prior area rate proceedings and is dealt with by Judge Fahy (APGA, A. 95-96). The opinion points out that under the decisions of this Court in *U.S. v. Allegheny-Ludlum Steel Corp.*[10] and *U.S. v. Florida East Coast Railway Co.,*[11] an adjudicatory hearing with cross examination is required in ratemaking only where the underlying statute is of a kind specified in Sections 556 and 557 of the Administrative Procedure Act, and that the Natural Gas Act does not fall within this category. The Judge points out that a fair and reasonable hearing procedure must be used but it need not fit the pattern demanded by Petitioner.

The Petition contends at p. 26 that the "substantial evidence" rule of Section 19(b) of the Natural Gas Act (15 U.S.C. § 717r(b)) is the "key point" in support of an adversary hearing. But the opinion of Judge Fahy, for a unanimous court, points out:

> We have not overlooked the contention that the provision of the Natural Gas Act requiring substantial evidence to support an essential element of the Commission's order, *Permian,* 390 U.S. at 792, calls for a trial-type hearing. Section 15(b) of the Natural Gas Act, 15 U.S.C. § 717r(b). In our view, however, this requirement, found in the judicial review provision of the Act, does not dictate the procedure to be followed, or the nature of the hearing to be held. It has to do with a court's review of the adequacy *vel non* of the evidence relied upon to support a finding, whatever the kind of hearing. True it may be that when rulemaking is based on written submissions the weight to be accorded the evidence may be affected by that method of presentation, but the standard of substantial evidence may be satisfied by written submissions. (APGA, A. 100-101)

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[10] *U.S. v. Allegheny-Ludlum Steel Corp.*, 406 U.S. 742, 758 (1972).

[11] *U.S. v. Florida East Coast Railway Co.*, 410 U.S. 224 (1973).

The Petition relies, at length, on the 1973 decision of the Court below in *Mobil Oil Corp. v. FPC*[12] and this, in turn, is discussed by Judge Fahy, as appears at pp. 95, 97 and 98 of APGA's Appendix. That earlier *Mobil* Opinion involved a rulemaking proceeding in which the Commission promulgated a uniform pipeline charge for transporting liquids through gathering lines without having given parties an opportunity to develop a record. The Commission incorporated such data as it desired into the record on its own motion and issued its order without notice. The Court below reversed and remanded the case for lack of adequate notice, but the opinion includes a lengthy discussion of hearing requirements. Insofar as this issue was concerned the opinion was dicta and the subsequent decision of the same court in *American Public Gas Association v. FPC, supra,* is squarely in conflict with such dicta. The opinion of Judge Fahy so states, at APGA, A. 98.

The opinions of the Court below make plainly evident that the Commission gave all parties, including APGA, full opportunity to introduce evidence on all issues; that numerous parties, including the UDC Group, availed themselves of this opportunity; and that all parties, including APGA, were given full opportunity to respond to all contentions by evidence, comments and oral argument of their own.

But, while, as Judge Fahy points out, a "massive" record was assembled, that record is devoid of any sworn evidence introduced by APGA on any issue. Nor did APGA seek, by interrogatory or otherwise, to secure basic data from producers or other parties.

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[12] *Mobil Oil Corp. v. FPC,* 483 F.2d 1238 (D.C. Cir. 1973).

The comprehensive decisions of Judge Fahy and Judge Leventhal give ample evidence that the procedure was fair and reasonable to all, including APGA, and should not be disturbed.

Respectfully submitted,

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